

Z Energy

NEUTRAL

Retail Fuel Market Study Results to be Revealed Thursday

On Thursday 5 December, the Commerce Commission (ComCom) will be releasing its final Retail Fuel Market Study report. We believe it is likely to walk back from some of its draft statements, with retail fuel market competition intensifying in the past few months. Our understanding is that retail competition remains tough and hence Z Energy's (ZEL) earnings remain under pressure (consistent with expectations). In addition, refining margins are down, causing additional margin pressures for ZEL.

What's changed?

- **Earnings:** FY20 EBITDAF cut -\$7m to \$389m (one-off earnings hit)
- **Target Price:** -9cps lower to \$5.11 (ZEL is ex-dividend)
- **Rating:** NEUTRAL rating retained

ComCom Retail Fuel Study to be revealed on Thursday

On Thursday 5 December, the ComCom will release its final report on the Retail Fuel Market. We expect it to walk back from some of its draft conclusions, in particular that ZEL's ROIC is above 20% (although we expect the ComCom will still conclude ZEL is "over-earning"). The ComCom's draft report included possible solutions, including opening up the "borrow and loan" system to third parties. There is a reasonable chance that the ComCom decides not to provide any recommendations, but if it does, we anticipate that the potential "borrow and loan" recommendation will be replaced with a recommendation to move to terminal gate pricing — something ZEL has advocated.

Retail competition of greater concern than regulation

In our view, the retail competition is having a greater impact on ZEL earnings than anything that may come from the ComCom on Thursday. Retail margins have been under pressure since July and our understanding is that there has been little change in the last month (consistent with expectations).

Refining margin collapse not helping ZEL's earnings

The Singapore complex refining margin has collapsed in the past few weeks, which is impacting on Refining NZ (NZR) margins and in turn ZEL. We have lowered our NZR FY19 gross refining margin assumption -17% to US\$5.45/barrel. The flow on effect to ZEL is lowering the refining contribution -\$5m and our NZR dividend -\$2m. In the past, ZEL has been able to offset reduced NZR refining margins in the retail market, however, we do not believe that is possible at this point in time.

ZEL looking increasingly good value, but ...

At \$5.14, ZEL appears to be very good value. The gross dividend yield (at 48cps) is 13.0% and the FY20 PE is 13.8x. However, the market is clearly not convinced that 48cps is sustainable. Our analysis suggests the market is pricing in a sustainable dividend of ~36cps, -12cps below the bottom of its guidance range, which in turn implies a retail margin ~-15% lower than current margins.

Investment View

Our rating is NEUTRAL. Whilst ZEL entices investors with a very attractive dividend yield, challenges in the retail market and the ComCom Fuel Study means further earnings and therefore dividend downside cannot be ruled out. We believe ZEL has to once again demonstrate it is able to deliver sustainable earnings, preferably with less volatility than the past two years.

NZX Code	ZEL
Share price	NZ\$5.14
Target price	NZ\$5.11
Risk rating	Medium
Issued shares	400.0m
Market cap	NZ\$2,056m
Average daily turnover	850.1k (NZ\$5,076k)

Share Price Performance



Financials: March	19A	20E	21E	22E
NPAT* (NZ\$m)	195.8	148.6	164.0	164.2
EPS* (NZc)	49.0	37.1	41.0	41.1
EPS growth* (%)	-7.4	-24.1	10.4	0.1
DPS (NZc)	43.0	48.0	48.0	48.0
Imputation (%)	100	100	100	100

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	6.4	7.5	7.2	7.3
EV/EBIT	8.9	12.0	10.8	10.9
PE	10.5	13.8	12.5	12.5
Price / NTA	8.8	45.9	33.6	n/a
Cash dividend yield (%)	8.4	9.3	9.3	9.3
Gross dividend yield (%)	11.6	13.0	13.0	13.0

*Historic and forecast numbers based on underlying profits

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Z Energy (ZEL)

Priced as at 02 Dec 2019: NZ\$5.14

March year end

Forsyth Barr valuation		Valuation Ratios					2018A	2019A	2020E	2021E	2022E	
Valuation methodology		Blend of spot valuations					EV/EBITDA (x)	6.4	6.4	7.5	7.2	7.3
12-month target price (NZ\$)*		5.11		Spot valuations (NZ\$)		EV/EBIT (x)	8.3	8.9	12.0	10.8	10.9	
Expected share price return	-0.6%	1. DCF	4.93	Price/NTA (x)	9.7	10.5	13.8	12.5	12.5			
Net dividend yield	9.3%	2. Dividend Yield	5.33	Free cash flow yield (%)	16.4	8.8	45.9	33.6	27.5			
Estimated 12-month return	8.8%	3. Market Multiple	5.21	Net dividend yield (%)	6.3	8.4	9.3	9.3	9.3			
Key WACC assumptions		DCF valuation summary (NZ\$m)					Gross dividend yield (%)	8.7	11.6	13.0	13.0	
Risk free rate	2.00%	Total firm value	3,044	Imputation (%)	100	100	100	100	100	100		
Equity beta	0.84	(Net debt)/cash	906	Pay-out ratio (%)	61	88	129	117	117			
WACC	7.1%	Value of equity	2,055	Capital Structure		2018A	2019A	2020E	2021E	2022E		
Terminal growth	-2.0%	Shares (m)	400	Interest cover EBIT (x)	6.7	6.1	3.8	4.4	4.7			
Profit and Loss Account (NZ\$m)		2018A	2019A	2020E	2021E	2022E	Interest cover EBITDA (x)	8.6	8.5	6.1	6.6	7.0
Sales revenue	4,570	5,450	5,166	5,169	5,079	Net debt/ND+E (%)	57.2	55.4	63.9	64.5	64.8	
Normalised EBITDA	448	435	389	420	413	Net debt/EBITDA (x)	1.8	1.9	2.76	2.48	2.44	
Depreciation and amortisation	(102)	(122)	(147)	(141)	(137)	Key Ratios		2018A	2019A	2020E	2021E	2022E
Normalised EBIT	347	312	241	279	276	Return on assets (%)	12.4	11.0	7.8	9.2	9.3	
Net interest	(52)	(51)	(64)	(63)	(59)	Return on equity (%)	24.2	21.7	17.9	20.7	21.6	
Associate income	1	(1)	(1)	-	-	Return on funds employed (%)	17.4	15.8	10.5	12.4	12.8	
Tax	(82)	(61)	(47)	(60)	(61)	EBITDA margin (%)	9.8	8.0	7.5	8.1	8.1	
Minority interests	-	(2)	(19)	(9)	(8)	EBIT margin (%)	7.6	5.7	4.7	5.4	5.4	
Normalised NPAT	211	196	149	164	164	Capex to sales (%)	1.9	1.0	1.7	0.9	0.9	
Abnormals/other	(6)	(16)	(35)	-	-	Capex to depreciation (%)	140	85	107	57	58	
Reported NPAT	205	180	114	164	164	Operating Performance		2018A	2019A	2020E	2021E	2022E
Normalised EPS (cps)	52.9	49.0	37.1	41.0	41.1	Product volumes (m litres)	Petrol	1,204	1,165	1,136	1,139	1,126
DPS (cps)	32.3	43.0	48.0	48.0	48.0	Diesel - retail	461	454	446	438	427	
Growth Rates		2018A	2019A	2020E	2021E	2022E	Diesel - commercial	807	812	799	831	846
Revenue (%)	18.3	19.3	-5.2	0.1	-1.7	Diesel - biofuels	-	1	6	14	22	
EBITDA (%)	6.9	-2.9	-10.7	8.2	-1.6	Other fuels	1,153	1,193	1,156	1,171	1,186	
EBIT (%)	3.3	-10.1	-22.8	15.7	-0.9	Supply - domestic	520	544	551	566	574	
Normalised NPAT (%)	8.2	-7.4	-24.1	10.4	0.1	Sub-total	4,145	4,168	4,094	4,159	4,180	
Normalised EPS (%)	8.2	-7.4	-24.1	10.4	0.1	Supply - industry & export	178	280	82	102	100	
DPS (%)	10.2	33.1	11.6	0.0	0.0	Total Fuels	4,323	4,448	4,176	4,260	4,280	
Cash Flow (NZ\$m)		2018A	2019A	2020E	2021E	2022E	Retail service stations	343	343	340	336	339
EBITDA	448	435	389	420	413	Petrol/service station (m litres)	3.64	3.53	3.45	3.48	3.44	
Working capital change	61	(159)	16	(8)	7	Diesel/service station (m litres)	1.34	1.32	1.31	1.29	1.26	
Interest & tax paid	(103)	(161)	(140)	(130)	(128)	Gross profit (NZDm)		2018A	2019A	2020E	2021E	2022E
Other	(15)	223	(192)	(4)	(4)	Fuels	685	700	654	658	653	
Operating cash flow	391	338	72	279	289	Refining	77	54	63	72	69	
Capital expenditure	(87)	(55)	(88)	(46)	(47)	Non-fuels	76	81	76	80	82	
(Acquisitions)/divestments	18	(28)	36	-	-	Flick Electric	-	1	4	7	9	
Other	12	4	2	6	6	Gross profit	838	836	798	816	813	
Funding available/(required)	334	259	22	239	247	Fuels gross margin (cpl)	16.5	16.8	16.0	15.8	15.6	
Dividends paid	(134)	(152)	(198)	(192)	(192)	Fuels margin incl refining (cpl)	17.6	17.0	17.2	17.1	16.9	
Equity raised/(returned)	(2)	(1)	(14)	(14)	(14)	Fuels margin excl supply (cpl)	18.3	18.0	17.5	17.5	17.3	
Increase/(decrease) in net debt	(198)	(106)	190	(33)	(41)	Non-fuels revenue/station (NZD 000)	373	398	378	397	407	
Balance Sheet (NZ\$m)		2018A	2019A	2020E	2021E	2022E	Refining volume (m barrels)	21.3	19.7	20.8	21.2	21.3
Working capital	196	358	363	370	364	Sales sourced from refinery (%)	82	75	81	81	81	
Fixed assets	870	830	806	781	757	ZEL refining margin (USD/barrel)	8.6	6.2	6.4	7.0	7.0	
Intangibles	750	668	785	733	685	Flick customer numbers (000)	-	20.5	20.2	26.2	31.7	
Other assets	134	161	219	219	219	Total funding sources		1,950	2,017	2,173	2,103	2,024
Total funds employed	1,950	2,017	2,173	2,103	2,024							
Net debt/(cash)	824	827	1,071	1,044	1,008							
Other non current liabilities	269	270	263	257	249							
Shareholder's funds	857	920	839	802	766							
Minority interests	-	-	-	-	-							

* Forsyth Barr target prices reflect valuation rolled forward at cost of equity less the next 12-months dividend

Refining margins taking a hit ahead of IMO 2020

Figure 1. Bloomberg Singapore benchmark margin



Source: Bloomberg, Forsyth Barr analysis

Forecast changes

Figure 2. Summary forecast changes

	FY20	FY20	%	FY21	FY21	%	FY22	FY22	%
	Old	New	Chg	Old	New	Chg	Old	New	Chg
Revenue	5,168	5,166	0%	5,169	5,169	0%	5,079	5,079	0%
Gross profit	807	800	-1%	822	822	0%	819	819	0%
Gross Margin	15.6%	15.5%	-1%	15.9%	15.9%	0%	16.1%	16.1%	0%
Operating costs	(411)	(411)	0%	(402)	(402)	0%	(405)	(405)	0%
EBITDAF	396	389	-2%	420	420	0%	413	413	0%
Depreciation & amortisation	(147)	(147)	0%	(141)	(141)	0%	(137)	(137)	0%
EBIT	249	242	-3%	279	279	0%	276	276	0%
Net Interest	(64)	(64)	0%	(63)	(63)	0%	(59)	(59)	0%
Other	(38)	(38)	0%	-	-		-	-	
Pre-tax profit	148	140	-5%	216	215	0%	217	217	0%
Tax expense	(49)	(47)	-4%	(60)	(60)	0%	(61)	(61)	0%
NPAT	98	93	-5%	155	155	0%	156	156	0%
Minority interest	19	19	0%	9	9	0%	8	8	0%
NPAT post-minorities	117	112	-5%	164	164	0%	164	164	0%
Normalised Profit	154	149	-3%	164	164	0%	164	164	0%
Earnings per share (eps)	38.5	37.1	-3%	41.0	41.0	0%	41.1	41.1	0%
Dividend (cps)	48.0	48.0	0%	48.0	48.0	0%	48.0	48.0	0%

Source: Forsyth Barr analysis

What's the share price saying?

Figure 3. Dividend yield and retail margin implications at \$5.15

Retail margin (cpl)	17.0	17.9	18.7	19.6	20.5	21.4	22.2	23.1	24.0	24.9	25.8	26.6
Retail margin change (cpl)	(7.0)	(6.1)	(5.3)	(4.4)	(3.5)	(2.6)	(1.8)	(0.9)	0.0	0.9	1.8	2.6
EBITDAF (\$m)	278	292	306	320	333	347	361	375	389	403	417	431
EBITDAF change (\$m)	(111)	(97)	(83)	(69)	(56)	(42)	(28)	(14)	0	14	28	42
Dividend (cps)	25.0	27.5	30.0	32.5	35.0	37.5	40.0	42.5	45.0	47.5	50.0	52.5
Cash dividend yield	4.9%	5.4%	5.8%	6.3%	6.8%	7.3%	7.8%	8.3%	8.8%	9.2%	9.7%	10.2%
Gross dividend yield	6.8%	7.4%	8.1%	8.8%	9.5%	10.1%	10.8%	11.5%	12.2%	12.8%	13.5%	14.2%

Source: Forsyth Barr analysis

Note: The bottom of ZEL's FY20 EBITDAF guidance range is \$390m. Our analysis indicates that \$390m EBITDAF would ordinarily support a 45cps dividend, -3cps lower than the bottom of ZEL's dividend guidance range of 48cps. We understand that ZEL has included asset sale proceeds in its FY20 dividend guidance, which we have removed in the above analysis.

Investment summary

Our rating is **NEUTRAL**. Whilst ZEL entices investors with a very attractive dividend yield, challenges in the retail market and the ComCom Retail Market Fuel Study means further earnings and therefore dividend downside cannot be ruled out. We believe ZEL has to once again demonstrate to the market it is able to deliver sustainable earnings, preferably with less volatility than the past two years.

Business quality

- **Industry structure:** The industry is an oligopoly dominated by ZEL, BP, and Mobil (Exxon). ZEL's NZ-centric business model provides it with a market leading position. ZEL sells ~45% of NZ fuel volumes.
- **Refining performance:** ZEL refines ~75% of its product at NZR. NZR is generally a positive and provides a competitive advantage over imported product when refining margins are high.

Earnings and cash flow outlook

- **Fuel margins:** Fuel margins are the key value driver and with retail competition intensifying, are becoming increasingly volatile. Commercial margins remain stable.
- **Sales volumes:** Fuel demand is generally inelastic, so whilst it is an important value driver its variability is less than margins. However, volumes are important for maintaining supply chain economics.
- **Strategy 3.0:** ZEL has guided to earnings growth of +\$35m to +\$40m above underlying FY17 earnings. Growth is predominantly coming from extra Caltex/Z merger benefits and jet fuel being repriced to import parity.

Company description

Z Energy is a downstream oil company. Its products include petrol, diesel, marine fuel oil and aviation fuel. Z retails petrol and diesel through a network of ~200 Z branded service stations and ~140 Caltex branded service stations. It sells fuel to the commercial market, which includes a network of 161 truck stops. ZEL also owns terminal storage facilities in 12 centres, share of local distribution ships and distribution infrastructure, 15% of Refining NZ (NZR), 25% of Loyalty NZ (Fly Buys) and 70% of electricity retailer Flick Electric. It has also recently opened a bio-diesel plant in Wiri, South Auckland.

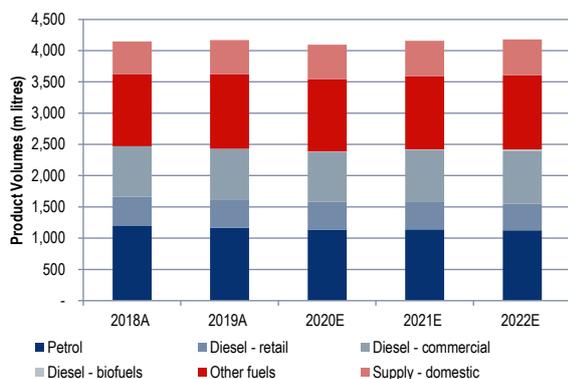
Financial structure

- **Dividend growth:** ZEL has significant free cash flow. We anticipate the FY20 dividend will be 48cps, which still allows for some debt repayment. ZEL is targeting net debt/EBITDAF of 1.6x–2.0x by the end of FY21.
- **Flick Electric:** ZEL has acquired a 70% stake in electricity retailer Flick Electric. We do not expect it to impact on earnings in the near-term.

Key risks

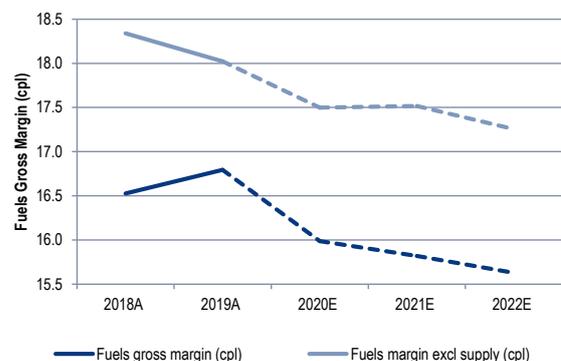
- **Long-term threat to industry volumes:** Increased vehicle efficiency and the threat from electric vehicles will pressure industry volumes. However, the near-term risks are low with industry volumes growing.
- **Retail Fuel Market Study:** High fuel margins have created political noise about fuel prices, resulting in legislation enabling the Commerce Commission to undertake market studies. The study is due by the end of 2019.

Figure 4. Fuel volumes



Source: Forsyth Barr analysis

Figure 5. Fuels gross margin



Source: Forsyth Barr analysis

Figure 6. Substantial Shareholders

Shareholder	Latest Holding
Lazard	6.7%
ACC	6.1%
Commonwealth Bank of Australia	6.1%
Investor Mutual	5.1%

Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

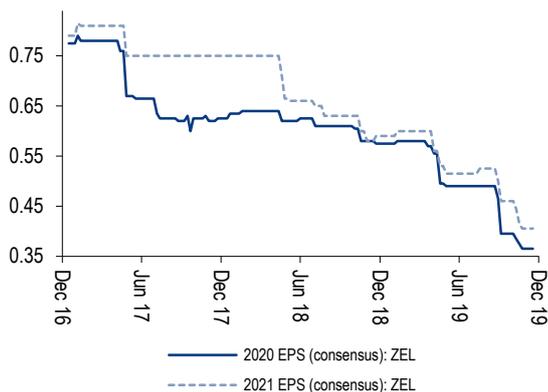
Figure 7. International Compcos

Company	Code	Price	Mkt Cap (m)	PE		EV/EBITDA		EV/EBIT		Cash D/Yld
				2020E	2021E	2020E	2021E	2020E	2021E	2021E
<i>(metrics re-weighted to reflect ZEL's balance date - March)</i>										
Z Energy	ZEL NZ	NZ\$5.14	NZ\$2,056	13.8x	12.5x	7.4x	6.9x	12.0x	10.3x	9.3%
Suburban Propane Partners LP	SPH US	US\$22.42	US\$1,392	17.9x	15.6x	9.5x	9.2x	17.3x	n/a	10.8%
World Fuel Services Corp	INT US	US\$42.40	US\$2,773	16.8x	14.2x	8.1x	7.6x	10.4x	9.8x	n/a
Contact Energy *	CEN NZ	NZ\$7.12	NZ\$5,111	20.0x	19.9x	12.7x	12.6x	22.1x	21.8x	5.5%
Mercury *	MCY NZ	NZ\$4.81	NZ\$6,546	26.5x	24.3x	14.9x	14.6x	24.5x	23.8x	3.4%
Trustpower *	TPW NZ	NZ\$7.35	NZ\$2,300	24.1x	22.5x	14.1x	13.7x	17.5x	16.9x	4.6%
Meridian Energy *	MEL NZ	NZ\$4.62	NZ\$11,828	24.7x	27.0x	16.1x	17.3x	25.5x	28.6x	4.7%
Genesis Energy *	GNE NZ	NZ\$3.19	NZ\$3,284	20.9x	17.7x	12.3x	11.2x	28.4x	24.3x	5.5%
Caltex Australia	CTX AT	A\$34.79	A\$6,687	23.2x	16.8x	10.9x	9.1x	16.6x	13.2x	3.5%
Viva Energy Group	VEA AT	A\$2.28	A\$4,424	n/a	17.4x	11.0x	9.2x	18.6x	14.5x	3.9%
Compcos Average:				21.8x	19.5x	12.2x	11.6x	20.1x	19.1x	5.2%
ZEL Relative:				-36%	-36%	-39%	-41%	-40%	-46%	+78%

EV = Current Market Cap + Actual Net Debt

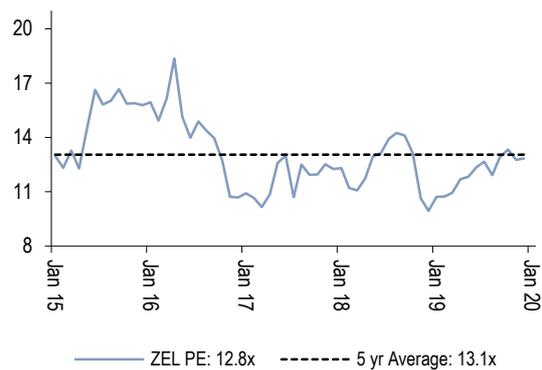
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compcos metrics re-weighted to reflect headline (ZEL) companies fiscal year end

Figure 8. Consensus EPS Momentum



Source: Forsyth Barr analysis, Bloomberg

Figure 9. 12 Month Forward PE



Source: Forsyth Barr analysis

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